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TO RUEHC/SECSTATE WASHDC 6360
INFO RUEHBO/AMEMBASSY BOGOTA 7008
RUEHBU/AMEMBASSY BUENOS AIRES 1472
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RUEHQT/AMEMBASSY QUITO 2435
RUEHSG/AMEMBASSY SANTIAGO 3777
RUEHGL/AMCONSUL GUAYAQUIL 0670
RUCPDOC/DEPT OF COMMERCE
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TREASURY FOR KLINGENSMITH AND NGRANT
COMMERCE FOR 4431/MAC/WH/MCAMERON
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TAGS: EFIN ECON PGOV VE
SUBJECT: INFLATION GOING UP, UP, AND AWAY IN THE BRV

REF: A. CARACAS 02718

¶B. CARACAS 02825

SUMMARY

¶1. (SBU) Inflation rose 2.2 percent in August, reaching a total of 10.4 percent for 2006 and implying an annual rate exceeding 15 percent. The BRV is now incapable of meeting its inflation target for 2006 of 10 percent and recent statements by Chavez and senior BRV officials demonstrate that the BRV has become increasingly concerned about the effect inflation is having on public support for the Bolivarian Revolution. At the same time, the government shows no signs of slowing spending (one of the principal causes of inflation) as it tries to buy support for the December elections.

NUMBERS

¶2. (U) Official inflation rose 2.2 percent in August and shows a worrying trend for the remainder of 2006. Food and drinks showed the largest increase (4.3 percent) and there were also significant increases in the cost of transportation (2.8 percent), housing (2.4 percent) and hotels and restaurants (1.9 percent). The price of foodstuffs between August 2005 and August of 2006 has increased 26.7 percent and during this time the overall Consumer Price Index (CPI) rate has increased 14.9 percent.

¶3. (U) Inflation is particularly damaging for the poorest segments of society. Venezuela,s 2 million impoverished households (31.5 percent of all households), or about 9 million people spend half of their income on foodstuffs and the increase in prices hits them the hardest. The current basic basket of goods and services for a family of five costs 1,789,768 bolivars (USD 832) a month, which economists estimate only 20 percent of Venezuelans can afford. An increase in the minimum wage this month (from approximately

USD 216 per month to USD 238 per month) will do little to alleviate the burden as increases in salaries are not keeping up with inflation.

¶4. (SBU) Official inflation numbers are also misleading. A recent canvassing of business leaders at a VENAMCHAM meeting implies that actual inflation is running at significantly higher levels than stated. (Note: As high as 20-22 percent. End note.) In addition, price-controlled goods (which rose 1.5 percent in August) are distorting the market and hide real inflation. As an example, white sugar is supposed to sell for 1200 bolivars a kilogram (56 cents). Widespread sugar shortages last month left shelves bare as the import cost exceeded the controlled sale price. (Note: Venezuela's domestic sugar production is insufficient to meet demand, and approximately 60-70 percent of the annual crop alone goes to carbonated beverages. End note.) Since the government bought 60,000 tons of sugar from Brazil, it has returned to supermarket shelves, but is on sale for approximately 3000 bolivars per kilo. In the basket of goods used to judge inflation, the price of sugar has not changed (masking a 150 percent real increase). In the government subsidized Mercal markets, a kilo of sugar (when available) costs 750 bolivars.

¶5. (U) There is also a gap between increases in the CPI, on which this report is based, and changes in the wholesale price index (WPI) that demonstrates costs for suppliers and manufacturers. After growing significantly faster than CPI in 2004 and 2005, WPI is growing at an annualized rate of 12.2 percent (or 2.7 points lower than CPI).

CAUSES

¶6. (SBU) Inflation in Venezuela is a result of a variety of factors as predicted by orthodox economics. Liquidity (the amount of money in the economy) has increased 60 percent since August 2005, and since 1998 has increased by over 730 percent. Santander, an economic consultancy, estimates that the amount of excess liquidity in Venezuela exceeds USD 19 billion. Oil revenues entering the economy are increasing liquidity, as is government spending. Government expenditures have increased 95 percent in dollar terms since 1999 (see reftel A). In addition the government is creating incredible amounts of money. A noted economist observes that as PDVSA repatriates a dollar, the Central Bank (BCV) converts that dollar into bolivars for PDVSA and then has been transferring another dollar (USD 10.7 billion since September 2005) in &excess reserves8 to the National Development Fund (FONDEN), thus creating a dollar out of thin air.

¶7. (SBU) Increased government spending and currency controls are also causing large increases in consumption, which fuels inflation as demand outpaces supply. The over-valued exchange rate (estimates range from 20 to 25 percent) makes imports cheaper, but also encourages short term consumption (as everyone expects the BCV to devalue at some point in the future). People are also discounting the future (due to political and economic instability) in other ways and more than one analyst has commented that long term planning in the BRV means 3 months.

¶8. (SBU) Despite the fact that inflation is running at least at 15 percent annually, the nominal interest rates for savings accounts is below 10 percent. For Venezuelans, there is a huge disincentive to save money as interest rates below inflation mean that their money loses value every day it is in their account. (Comment: The BRV is probably hesitant to raise interest rates as it wants to avoid slowing the economy or raising the burden for the already debt-laden public. End comment.)

¶9. (SBU) The government is also holding large amounts of demand deposits in private sector banks (see reftel A). Banks are using government deposits to make loans, increasing the money supply further. (Note: Estimates are that for every

1 dollar of government deposits, banks create 3 dollars in additional liquidity. End note). The recent decrease in interest rates from 10 to 6 percent on government certificates of deposit (CDs) has meant that banks can no longer profit from arbitrage (paying Venezuelans 6-8 percent interest on savings accounts and then using those funds to buy CDs at 10 percent). Instead banks will now try to increase their loan and credit card portfolios, which will cause an increase in consumer spending.

HISTORICAL PRECEDENT

¶10. (U) Venezuela, like many Latin American countries, has had a recurring problem with inflation. During the past two decades, inflation has ranged from 8.8 to almost 100 percent a year. Spikes in inflation have been historically associated with increases in oil prices, but are also contingent on monetary policy. The mid 1990s were characterized by modest oil prices, yet very high inflation as successive governments were unable to break the cycle where deficit spending resulted in a devaluation, which in turn caused more inflation and necessitated more deficit spending.

GOVERNMENT RESPONSE

¶11. (U) During his weekly television program, &Alo Presidente,8 on September 3 Chavez played the role of Economics Professor in Chief for the BRV. With a series of graphs and charts behind him, Chavez explained to the Venezuelan public the historical precedents for the current state of the Venezuelan economy and how the BRV deserved much credit for current economic growth and "price stability." Chavez demonstrated the growth in the minimum wage as compared to the growth in inflation and said that in the early 1990s inflation outpaced wages. According to his chart, since 1998 the minimum wage has increased quicker than inflation (Note: though overall wages are about 20 percent less in real terms than in 1998). Chavez then discussed inflation with Minister of Planning and Development Jorge Giordani, who outlined the 28 percent increase in food costs and the shortages of tomatoes, peppers, and onions. Chavez made it very clear that the BRV must lower inflation, for example by increasing domestic production of tomatoes, and admitted that it was important to import goods to prevent shortages and price increases.

¶12. (U) The Committee for the Administration of Foreign Currency (CADIVI) has increased its authorizations in the past month and in August authorized USD 2.3 billion in conversions. The increases come at a time when it is under criticism from both the opposition and the National Assembly for helping fuel the fires of inflation by preventing money from leaving the system and imports from entering the market (importers need CADIVI to get dollars to buy goods to import). (Note: An increase in imports may temporarily alleviate inflation as supply catches up with demand, though does nothing to deal with the longer term issues of de-industrialization occurring in Venezuela. End note.)

¶13. (SBU) The BRV is also attempting to reduce the money supply in the economy. The USD 1 billion, dollar-denominated &bonos de sur8 issuance planned by Venezuela (USD 500 million) and Argentina (USD 500 million) would reduce the supply of bolivars. The issuance has been delayed as contacts note that Argentina does not need additional financing this year. Nonetheless, Finance Committee Chairman Rodrigo Cabezas has announced that the BRV will issue bonds (per Chavez,s insistence) before October 15.

¶14. (SBU) The past week saw announcements that PDVSA may a) issue USD 3.5 billion in dollar-denominated bonds on the local market (see reftel B) and b) will send USD 4-6 billion in excess dollar profits to be held in escrow in a special

Treasury account. While both of these actions would reduce liquidity, the director of a local economic consultancy is doubtful they will occur as the debt issuance has been criticized as unnecessary (why take on debt when PDVSA is making huge profits from high oil prices). The treasury account is supposed to be inviolate, but the BRV has a long history of raiding supposedly inviolate accounts (such as foreign reserves at the BCV). In a normal country such inflation-fighting measures would fall under the purview of the Central Bank rather than the state oil company.

¶15. (SBU) Other measures the BRV is floating for controlling inflation are reducing the Value Added Tax (IVA), enacting more price controls, increasing imports, and punishing price gougers. These actions, while unlikely to do much to combat systemic inflation or help the economy, could bring some short-term relief or have a public relations benefit, and so are likely to occur in the run up to December. Contacts in the retail sector worry that Chavez will force a confrontation with some supermarkets and start shutting them down in November. This would be damaging for the private sector and for the supply of foodstuffs, but in the weeks leading up to the election, could provide a boogeyman for the public to blame for inflation and shortages.

CONCLUSION

¶16. (SBU) The BRV seems preoccupied with inflation and at the same time incapable of stopping it, which places it in league with the majority of modern Venezuelan governments. During his Alo Presidente presentation, Chavez's economic explanations were open and he fully admitted to a flaw in the BRV's economic policies. Many analysts have labeled inflation the "Achilles heel" of the BRV and note that inflation tends to hurt the poorest segments (Chavez's base) of society the most.

¶17. (SBU) Proven orthodox measures to slow inflation include decreasing public spending, raising interest rates and draining liquidity. Rather than taking these difficult steps, it seems likely the BRV will continue its stopgap measures that further distort the economy and slowly emaciate the private sector, while at the same time touting solutions that mislead the public as to the true nature and causes of inflation. Embassy contacts estimate that the BRV can continue its spending binge for 1-2 years before the imbalances and deficits catch up, which combined with lower oil prices will result in economic upheaval, as has been the case in Venezuela,s series of boom and bust cycles ever since the 1970s.
WHITAKER